UNIVERSAL SERVICE ISSUES

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UNIVERSAL SERVICE PROBLEM

- Goal of Low Basic Service Prices
- High Degree of Rate Averaging
- Two Sources of Historical Universal Service Subsidy
  1. Explicit — About $1B
  2. Implicit — $6B - $19B
     - Toll/Access → Local
     - Business → Residence
     - Urban → Rural
- Telecom Act of 1996 Changed Everything

IMPACTS OF 1996 ACT

- Prices Must Be Just, Reasonable and Affordable
- Implicit Support Must Be Replaced by Explicit Support
  - Specific
  - Predictable
  - Sufficient
- Customers in Rural and High-Cost Areas Should Have Services (Including Access to Advanced Services) and Prices Comparable to Those in Urban Areas
- Schools, Libraries and Rural Health Care Providers Should Have Access to Advanced Telecommunications Services
- Ability to raise basic service prices will be limited

THE FCC's DECISION

- Issued May 8, 1997
- Schools and Libraries
  - $2.25B Fund
  - Funding Based on State and Interstate Revenues
  - Sliding Scale of Discounts
- Rural, Insular and High Cost Areas
  - Funding 75% States / 25% Federal
  - "Non-Rural" Telephone Companies
    - Support = Forward-Looking Cost - Benchmark
    - 14 Month Process to Select Proxy Cost Model
  - "Rural" Telephone Companies
    - Continue Present Mechanisms
    - Transition to Forward-Looking Mechanism Beginning in 2001

KEY ISSUES

1. How big does the fund need to be?
   - The proxy cost models
2. To what geography should the fund be targeted?
   - Wire center?
   - Below the wire center?
3. How should required contributions to the fund be collected?
   - National fund?
   - Separate state and interstate funds?
4. How should implicit support be removed from the rate structure?

THE PROXY COST MODELS

- The Contenders:
  - HAI (Formerly Hatfield) Model (AT&T and MCI)
  - Benchmark Cost Proxy Model (U S WEST, BellSouth and Sprint)
- The Issues:
  - Customer Location
  - Loop Design
  - Input Factors
    - Material Prices
    - Capital Cost Factors
  - Objectives of the Study
    - Universal Service Funding
    - Unbundled Network Elements (UNEs)

THE BOTTOM LINE - HOW DO THE MODELS COMPARE?

	Dollars - Millions			
	BCPM3		Hatfield 5.0	
	Default	Common	Common	Default
Ameritech	$ 520	$ 232	$ 202	$ 111
Bell Atlantic	$ 1,047	$ 481	$ 595	$ 340
Bell South	$ 1,649	$ 761	$ 813	$ 480
SBC	$ 1,466	$ 771	$ 619	$ 407
US WEST	$ 1,225	$ 726	$ 629	$ 425
Sprint	$ 823	$ 368	$ 398	$ 240
	$ 6,730	$ 3,339	$ 3,256	$ 2,003

SUMMARY

- In aggregate, with common inputs the models produce similar results
- There are unexplained differences between the fund distributions to companies
- Input data will play an important role in determining ultimate fund size.

PUBLIC POLICY PERSPECTIVES

UNE PRICING

MAJOR OBJECTIVES

- Encourage local market entry
- Price at cost (TELRIC)
- Keep the costs low

IF COSTS ARE UNDERESTIMATED

- More competitors enter market (through resale)
- Adverse financial impact to the incumbent

IF COSTS ARE OVERESTIMATED

- Local entry discouraged

UNIVERSAL SERVICE

MAJOR OBJECTIVES

- Specific, Predictable and Sufficient support
- Affordable rural service
- Access to advanced services

IF COSTS ARE UNDERESTIMATED

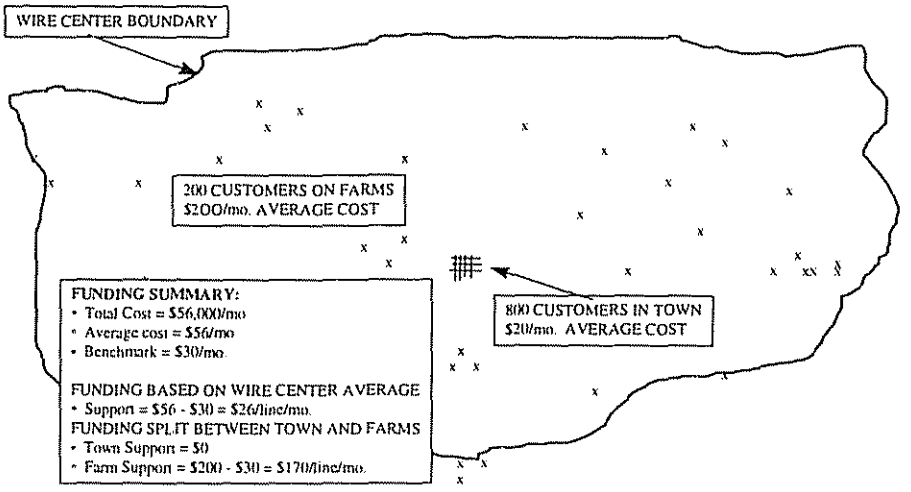
- Providers will not construct facilities to serve high-cost rural areas
- Rural rates will rise
- Rural customers will not have access to advanced services

IF COSTS ARE OVERESTIMATED

- ILECs and others will overpay to fund
- 'Gaming' of the system

UNE pricing may involve incentives to err on the low side. However underestimation of costs for universal service support can have severe public policy consequences. The Hatfield model was developed primarily for UNE pricing and tends to understate costs. The BCPM attempts to neither understate nor overstate forward-looking costs

SUPPORT MUST BE TARGETED BELOW THE WIRE CENTER



FUNDING STRUCTURE

- The FCC May 7, 1997 Decision Requires a 75/25 Split of Funding Between the State and Federal Jurisdictions
- 75/25 Will Threaten Affordability in Some States
  - Primary Drivers:
    - Number of High Cost Customers
    - Range of Costs
    - Number of Low Cost Customers

Funding Alternatives

1. NATIONAL FUND

$$\text{National \%} = \frac{\text{National Funding Requirements}}{\text{State + Interstate Revenues}}$$

2. SEPARATE STATE AND INTERSTATE FUNDS

$$\text{State \%} = \frac{\text{75\% Of State Funding Requirements}}{\text{State Revenues}}$$

$$\text{Interstate \%} = \frac{\text{25\% Of National Funding Requirements}}{\text{Interstate Revenues}}$$

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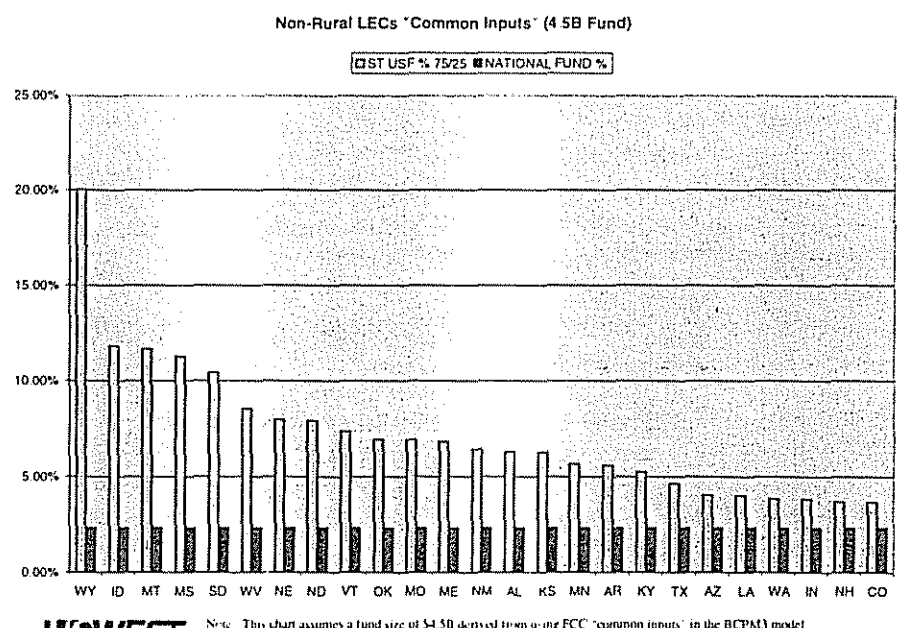

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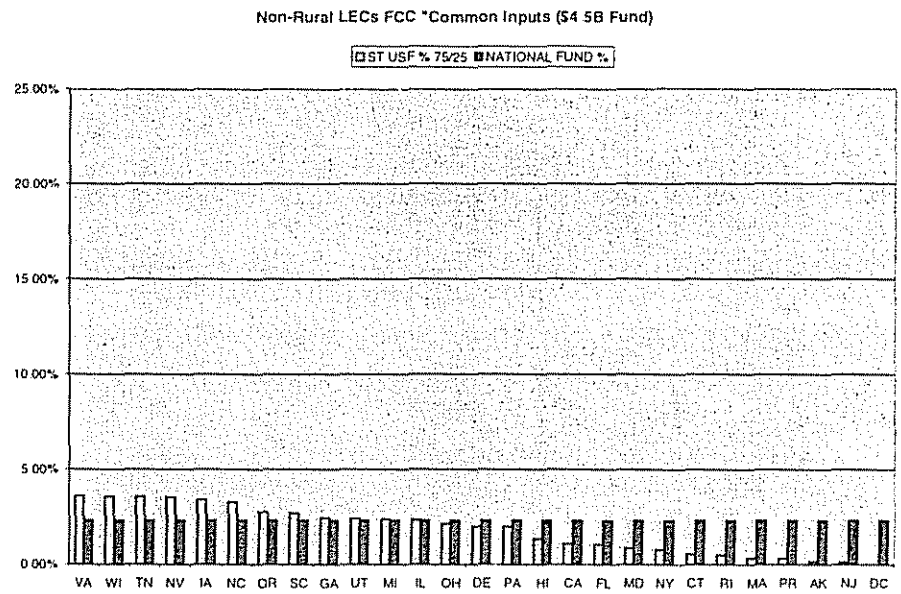
Note: This chart assumes a fund size of $4.5B derived from using FCC "common inputs" in the BCPM3 model. The actual fund size will be determined after completion of further proceedings to finalize model inputs.



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RATE REBALANCING

- Removal of implicit support presents a once-in-a-career opportunity to rebalance rates.
- The greater the rate rebalancing freedom granted by regulators, the smaller will be the size of the required explicit support fund.
- Rate rebalancing should benefit the evolution of competition.